ORIGINAL

STATE OF INDIANA

INDIANA UTILITY REGULATORY COMMISSION

PETITION OF LAWRENCEBURG GAS)	
COMPANY FOR APPROVAL TO INCREASE)	CAUSE NO. 43090
ITS RATES AND CHARGES FOR GAS	
SERVICE AND FOR AUTHORIZATION TO)	APPROVED: JUN 2 0 2007
IMPLEMENT A NORMAL TEMPERATURE)	0011 = 0 2001
ADJUSTMENT MECHANISM)	

BY THE COMMISSION

Gregory D. Server, Commissioner Loraine L. Seyfried, Administrative Law Judge

On July 28, 2006, Lawrenceburg Gas Company, Inc. ("Lawrenceburg", "Utility" or "Petitioner"), filed its Petition with the Indiana Utility Regulatory Commission ("Commission") seeking authority to increase its rates and charges for gas utility service and to implement a normal temperature adjustment mechanism. A Prehearing Conference was held on September 5, 2006, at which Petitioner and the Indiana Office of Utility Consumer Counselor ("OUCC") appeared and participated. On September 20, 2006, the Commission issued a Prehearing Conference Order in this Cause.

On September 14, 2007, Lawrenceburg submitted the prefiled testimony and exhibits of its accounting witnesses, Duane C. Mercer and Bonnie J. Mann. The remainder of the Utility's prefiled case-in-chief was submitted to the Commission on November 9, 2007. On December 13, 2007, the City of Aurora ("Aurora") filed a Motion to Intervene in this Cause, which was granted by the Presiding Officers on December 22, 2006. Also, on December 22, 2006, the OUCC and Aurora prefiled the direct testimony and exhibits of their respective witnesses. Lawrenceburg prefiled its rebuttal testimony and exhibits on January 8, 2007.

Pursuant to notice duly published, a public field hearing was convened in Lawrenceburg, Indiana on January 10, 2007, at which Lawrenceburg, the OUCC and Aurora appeared. Two individuals testified at the field hearing, and both gentlemen also provided written comments which were offered into the record by the OUCC and admitted without objection. The OUCC offered additional written comments from two other individuals — one a customer of Aurora, which is itself a wholesale customer of Lawrenceburg, and the other a customer in the Utility's Lawrenceburg division, which were also received into the record without objection.

The evidentiary hearing in this cause was conducted on January 24, 2007, pursuant to notice duly published as required by law. At the outset of the hearing, at which all three parties appeared by counsel, the OUCC orally moved to establish a subdocket for purposes of examining whether the assets of Lawrenceburg had been encumbered by its parent company without prior Commission approval. The Presiding Officers took the motion under advisement, and the parties agreed to address the issue in writing. The parties then offered the prefiled



testimony of their witnesses, who were made available for cross-examination. At the conclusion of the hearing, a procedural schedule was established for filing proposed orders and exceptions.

On January 29, 2007, the OUCC filed its Motion for Subdocket. On February 5, 2007, Lawrenceburg filed its Response and on February 8, 2007, the OUCC filed its Reply.

Having considered the evidence of record and the applicable law, the Commission now finds as follows:

- 1. <u>Notice and Jurisdiction</u>. Due, legal and timely notices of the Prehearing Conference and evidentiary hearings conducted in this Cause were given and published as required by law. Lawrenceburg is a "public utility" as defined in Ind. Code § 8-1-2-1(a) and is subject to the jurisdiction of the Commission in the manner and to the extent provided by the laws of the State of Indiana. Therefore, the Commission has jurisdiction over Lawrenceburg and the subject matter of this Cause.
- 2. <u>Utility's Characteristics</u>. Lawrenceburg is an Indiana corporation that owns and operates plant and equipment in the state for the delivery and sale of natural gas to residential, commercial and municipal customers.
- 3. Relief Requested. Lawrenceburg seeks authority to increase its base rates and charges. Lawrenceburg's existing rates and charges for gas utility service were established pursuant to the Commission's Order in Cause No. 39434-U on November 12, 1992. In its Petition, the Utility alleges that the revenues generated from its current base rates and charges are insufficient for its continued provision of safe and reliable service to its customers. The test year used by the Utility in this Cause as the basis for establishing new rates going forward was the twelve months ended April 30, 2006.

Although Lawrenceburg also included in its petition a request for authority to establish a normal temperature adjustment mechanism, it subsequently pursued this relief in a separate cause, IURC Cause No. 43141, which was then consolidated with eight similar requests from other gas utilities, all of which the Commission addressed in a December 6, 2006 Order in those consolidated causes. Therefore, this issue is not addressed in this Cause.

4. Rulings on Motions.

A. Confidentiality. On December 22, 2006, the OUCC moved for a temporary protective order covering certain exhibits it wished to submit with its responsive testimony that same date. Pursuant to a January 3, 2007 docket entry, the OUCC filed a revised motion on January 18, 2007, seeking the same relief ("Revised Motion"). On the same day, the Presiding Officers, finding the Revised Motion satisfied the criteria set forth in the Commission's procedural rule governing confidentiality requests, 170 IAC 1-1.1-4, issued a docket entry determining there was sufficient basis to hold the information confidential on a preliminary basis. During the evidentiary hearing in this Cause, the Presiding Officers also found, on a preliminary basis, that certain additional exhibits offered by the OUCC which, although not

specified in the OUCC's Revised Motion, constituted "confidential financial records" as described in Mr. Browner's affidavit and were exempt from public disclosure pursuant to Ind. Code § 5-14-3-4.

All the evidence submitted in this Cause supports the Presiding Officers' findings. Accordingly, the Commission finds that the information contains confidential financial information and is exempt from public disclosure in accordance with Ind. Code § 5-14-3-4(a).

B. <u>Subdocket</u>. At the evidentiary hearing in this Cause, the OUCC moved to establish a subdocket for purposes of examining whether the assets of Lawrenceburg had been encumbered by its parent company without prior Commission approval. As the Presiding Officers directed, the OUCC followed its oral motion at the evidentiary hearing with a written motion on January 29, 2007 ("Motion"). Lawrenceburg filed its Response on February 5, 2007, and the OUCC filed its Reply on February 8, 2007. The issue is whether the negative covenants contained within a credit agreement between two non-parties – a bank and INOH Gas, Inc. ("INOH"), the parent company of Lawrenceburg – constitute an "encumbrance" on the assets of Lawrenceburg as contemplated in Ind. Code § 8-1-2-83(a). If so, the credit agreement would have required approval by the Commission. While there is no dispute that INOH pledged as collateral for its loan the stock of Lawrenceburg that it owns, the OUCC makes the further assertion that the assets of the Utility were also pledged by the parent company as collateral for the loan.

Based on the early audit report and the overly broad language of the negative covenants, we can certainly understand the OUCC's initial concern that Lawrenceburg's assets may have been encumbered by the credit agreement without Commission approval. However, based upon the entirety of the evidence presented, we find that the credit agreement is unambiguous that the only assets pledged as collateral for the bank's loan to the Utility's parent company are the assets of the parent company, consisting of the stock of Lawrenceburg. The collateral for the loan is limited to "all property ... in or upon which a security interest, lien or mortgage is granted to the Bank under the Pledge Agreement...." See Loan Agreement at p. 3. The only property identified in the Pledge Agreement is the stock of Lawrenceburg.

Furthermore, Lawrenceburg and INOH are two separate legal entities. See Greater Hammond Cmty. Servs. v. Mutka, 735 N.E.2d 180, 784 (Ind. 2000) (distinct corporations, even parent and subsidiary, are presumed separate). No evidence has been offered to suggest otherwise. Nor has any evidence been offered that Lawrenceburg is a third party beneficiary of the credit agreement. Consequently, although the negative covenants may be overly broad, it is clear that Lawrenceburg is not a party to the credit agreement and is therefore not bound by the agreement. See Columbia Club Inc. v. Am. Fletcher Realty Corp., 720 N.E.2d 411, 417 (Ind. Ct. App. 1999), trans. denied, (holding that generally only a party to the contract can be held liable for its breach because contractual obligations are personal in nature).

We note also that this interpretation of the credit agreement is also confirmed by the lending bank. See Affidavit and attached clarification filed with the Utility's Response to the OUCC's Motion. Consequently, the Commission finds that neither the credit agreement nor the

negative covenants contained therein encumber any assets of Lawrenceburg and that no further investigation is warranted. Accordingly, the OUCC's Motion for a subdocket is denied.

5. Operating Revenues. Lawrenceburg's witness, Mr. Mercer testified that Lawrenceburg is not earning its authorized return on rate base as approved in its last rate case. Mr. Mercer recommended an increase of \$2,114,453 in operating revenues. He indicated that this would create an overall increase in test year revenues of 13.9% and produce an adjusted net operating income of \$1,522,402, which would result in a 9.99% overall return on original cost rate base.

Mr. Mercer proposed adjustments to operating revenue comprising of decreases totaling \$12,677,067 as follows: 1) elimination of \$9,550,082 in gas cost adjustment revenues; 2) an increase of \$383,667 for weather normalization; 3) a decrease of \$377,699 for the removal of unbilled revenue; 4) an increase of \$143,197 for a prior period billing adjustment; and 5) a decrease of \$3,276,151 to reflect the elimination of revenue to be collected through rates based on changes in the base cost of gas.

OUCC's Position. Mr. Grosskopf proposed only one change to Lawrenceburg's pro forma revenue adjustments. He did not agree with the removal of unbilled revenue as a decrease in operating revenue. Mr. Grosskopf testified that unbilled revenue is recorded to ensure revenues booked for delivery service are matched with expenses, and explained that unbilled revenue recognizes revenue for services rendered in a given period but not yet billed in that period. He stated that removing unbilled revenue prevents a complete twelve months of revenue from being recognized in the test year. Mr. Grosskopf testified that the process of accounting for unbilled revenue involves booking entries to revenue in the month that service is rendered, and that unbilled revenues are reversed as billing takes place.

Petitioner's Rebuttal. Mr. Mercer disagreed with Mr. Grosskopf's inclusion of a portion of unbilled revenue, and argued that inclusion of any part of unbilled revenue could produce a non verifiable result. Lawrenceburg's witness, Mr. Heid, also stated that unbilled volumes should be removed from actual test year revenues so that the billing volumes and revenues will be in synch. Mr. Heid stated that because the billing determinants are based on billing cycles, the test year revenues must also be on a billing cycle basis, *i.e.* without inclusion of unbilled revenues.

Commission Discussion and Findings. As Lawrenceburg's witness Kerry Heid pointed out, by consistently accounting for revenues based on the Utility's billing cycle, the actual billing volumes are synchronized with the full twelve months of revenues, which is critical for rate design purposes. Therefore, the Commission disagrees with the OUCC's proposed adjustment to the unbilled revenue.

6. Operating Expenses. Lawrenceburg proposed several adjustments to test year operating expenses. Mr. Mercer proposed a decrease of \$12,741,902 to purchased gas to eliminate the cost of gas from the Utility's base rates. Mr. Mercer testified that all gas costs incurred by Petitioner in the future will be included in the GCA process. Mr. Mercer also stated

that he included the expense of an economist for rebuttal testimony as part of the rate case expense. However, he indicated that to the extent rebuttal testimony of the economist was not filed, this amount could be reduced in the rate case expense adjustment.

Lawrenceburg's witness, Ms. Mann proposed an adjustment to operations and maintenance expense in the amount of \$139,488. This adjustment was comprised of an increase of \$100,933 for the annualization and increase in wages; an increase of \$35,000 for the amortization of rate case expenses; and an increase of \$3,555 for the IURC fee expense. Ms. Mann also proposed an adjustment of (\$158,589) in administrative and general expenses and an increase of \$78,730 in depreciation and amortization expense. Finally, Ms. Mann proposed three adjustments totaling (\$125,844) to taxes other than income taxes, and two adjustments to increase income taxes in the amount of \$399,937.

The OUCC's witness, Mr. Grosskopf, proposed an adjustment to Lawrenceburg's pro forma property and liability insurance expense as the total of all annual property and liability insurance declarations he reviewed was \$89,463. He stated that this was substantially less than Lawrenceburg's proposed pro forma insurance cost. He also testified that he removed certain test year legal expenses from the pro forma operating expenses which, in his opinion, were not related to the provision of utility service, but appeared to be for shareholder and investor activities. In addition, Mr. Grosskopf also testified that he updated Lawrenceburg's IURC fee using the rate in effect from July 1, 2006 through June 30, 2007, which resulted in an adjustment of \$3,009. Ms. Mann, in her rebuttal testimony, concurred with these changes proposed by the OUCC. Therefore, based upon the evidence, the Commission finds that Lawrenceburg's proforma property and casualty insurance expense is \$89,463; the pro forma legal expense is reduced by (\$15,422); and the pro forma IURC fee is increased \$3,009.

A. Bad Debt Expense.

OUCC's Position. Mr. Grosskopf testified that while he agreed with Lawrenceburg's methodology for calculating normalized bad debt, he did not believe that use of a four year average was warranted. He stated that Lawrenceburg used two full years of bad debt expense data from the previous owners. However, Mr. Grosskopf noted that aside from a large write-off from the previous owners, bad debt expense has been steadily declining in recent years. In addition, since the current owners have taken control, bad debt expense has declined significantly. Consequently, Mr. Grosskopf calculated an adjustment based on using the average of two years (2004 and 2005) of bad debt data.

Petitioner's Rebuttal. Ms. Mann disagreed with the OUCC's use of 2004 and 2005 data to calculate the Utility's bad debt expense as being unrepresentative of what Lawrenceburg can reasonably expect to experience in the future. Ms. Mann stated the test year bad debt expense was unusually high due to deferred write-offs and the bad debt expense for 2004 and 2005 was unusually low due to greater leniency with customers by the new owners of the Utility. Consequently, Petitioner believes an average of four years would provide a better estimate of future levels of bad debt expense.

Commission Discussion and Findings. Both parties agree that it is appropriate to make a downward adjustment to the amount of the Utility's bad debt expense of \$241,730 recorded during the test year. However, Lawrenceburg argues that a four year period average is appropriate for determining the amount of bad debt expense, whereas the OUCC argues that using an average of the 2004 and 2005 fiscal years is more representative. The Commission finds a two year average should be used to calculate the amount of bad debt expense as it better represents Lawrenceburg's bad debt expense on a going forward basis. Therefore, we find that Lawrenceburg's pro forma bad debt expense should be decreased by \$178,950.

B. Rate Case Expense.

OUCC's Position. Mr. Grosskopf adjusted Lawrenceburg's rate case expense to exclude the cost of an economist as a result of Mr. Mercer's testimony. Since the OUCC did not use highly technical and expensive cost of equity studies, Mr. Grosskopf made the adjustment alluded to in Mr. Mercer's testimony. He testified that such expense could be added back if the Utility hired an economist.

Petitioner's Rebuttal. Mr. Mercer disagreed with Mr. Grosskopf's elimination of the estimated cost of an expert economist. While Mr. Mercer agreed that Lawrenceburg's actual rate case expense will not include expenses associated with a separate cost of equity capital expert witness, he noted that the rate case expense estimated for this component has been more than offset by actual increases in other components of Lawrenceburg's estimated overall rate case expense. Mr. Mercer stated that Petitioner's rate case expenses were now expected to total at least \$188,000.

Commission Discussion and Findings. The OUCC proposed to reduce the Utility's rate case expense by the amount it had included for payment of an additional outside expert witness on the cost of capital. However, Lawrenceburg testified on rebuttal that its initial estimate of several other rate case expenses was too low and that the increase in actual rate case expenses has more than offset the estimate for the additional expert. Consequently, the Commission finds that although Lawrenceburg did not incur the expense of a separate economic expert, the increase in other expenses has resulted in actual rate case expenses that exceed the estimated rate case expense. While Lawrenceburg offered testimony concerning actual increases in several estimated costs which together exceed the estimated cost for a cost of capital expert, sufficient evidence of all estimated increases was not presented to allow us to determine the reasonableness of the total revised rate case expense. Therefore, we find that the OUCC's proposed reduction should not be made and that Lawrenceburg's annual rate case expense, amortized over four years, should be \$35,000.

C. Parent Company Interest Expense.

OUCC's Position. Mr. Grosskopf testified the ratepayers of Lawrenceburg should receive the tax benefit of INOH's long term debt. He stated that INOH and Lawrenceburg are "undeniably linked," and that INOH's only major asset is a 100% controlling interest in Lawrenceburg Gas. He also noted that INOH and Lawrenceburg filed consolidated financial

statements and combined tax returns; Lawrenceburg does not file or pay taxes on a stand alone basis. He further testified that if not for the revenue and income of Lawrenceburg, INOH would not be able to use the interest expense deduction because INOH has no other income of its own. Based upon the credit agreement interest rate and outstanding balance, Mr. Grosskopf calculated an interest expense tax deduction of \$542,875.

Petitioner's Rebuttal. Mr. Mercer disagreed with the OUCC's position regarding the interest expense deduction. Mr. Mercer stated the interest expense associated with INOH's long-term debt relates entirely to the acquisition of the common stock of Lawrenceburg. According to Mr. Mercer, this acquisition debt has nothing to do with any ongoing operational or capital projects related to Lawrenceburg and has no bearing on the calculation of the income tax expense of Lawrenceburg.

Commission Discussion and Findings. The evidence is undisputed that Lawrenceburg is the only subsidiary of INOH. INOH and Lawrenceburg file consolidated financial statements and combined federal tax returns. INOH does not file a separate federal return. Mr. Grosskopf correctly concluded that if not for the revenue and income of Lawrenceburg, INOH would not be able to use the interest expense deduction. This point was reiterated by Mr. Mercer at the hearing when he stated that payment of INOH's interest expenses occurs through payments by Lawrenceburg to INOH. See Transcript, pp. B-52 and B-53. Consequently, Lawrenceburg receives tax savings by filing a consolidated return.

Indiana case law requires the Commission to make a determination of Petitioner's actual tax liability. City of Muncie v. Public Service Commission, 378 N.E.2d 896 (Ind. Ct. App. 1978). The Commission cannot arbitrarily allow a tax expense computed on the basis of a separate tax return when such a return is not actually filed. Id. at 898-899. This has been held to be true regardless of the derivation of the tax benefits or the nature of the transactions between a regulated entity and its parent company. See, Office of Utility Consumer Counselor v. Indiana Cities Water Corporation, 440 N.E.2d 14 (Ind. Ct. App. 1982) requiring parent company tax losses not attributable to utility operations to be considered when a consolidated return is filed; see also, Matter of Communications Corporation, IURC Cause No. 37270 (Feb. 8, 1984), 1984 Ind. PUC LEXIS 795, *6 - *15; Petition of Indiana-American Water Company, IURC Cause No. 42520 (Nov. 18, 2004), 2004 Ind. PUC LEXIS 351, *306 - *308. The parent company interest allocation is intended to reflect for ratemaking purposes the benefits of the utility joining in a consolidated return. Petition of Indiana-American Water Company, 2004 Ind. PUC LEXIS at *306 - *308. Consequently, the Commission agrees with Mr. Grosskopf's recommendation and finds that an interest expense deduction in the amount of \$542,875 is reasonable and appropriate.

7. Rate Base. Mr. Mercer testified regarding the calculation of Lawrenceburg's original cost rate base. He testified that Petitioner's net utility plant in service is \$14,943,399; the working capital amount is \$233,734; and 13-month average of materials and supplies is \$62,127. Therefore, the original cost rate base proposed by Mr. Mercer is \$15,239,260.

OUCC's Position. Mr. Grosskopf agreed with Mr. Mercer's calculation of net utility plant in service and the materials and supplies amount. However, Mr. Grosskopf determined the

working capital amount at \$218,157. Thus, Mr. Grosskopf calculated the original cost rate base to be \$15,223,683.

Commission Discussion and Findings. The difference in the working capital amounts results from the difference between Mr. Mercer's and Mr. Grosskopf's pro-forma O&M expenses, and the flow through to the working capital calculation. Therefore, based upon the above expense adjustments as determined above, the Commission finds the total working capital requirement to be \$219,905, resulting in an original cost rate base of \$15,224,621.

8. <u>Capital Structure</u>.

A. Return on Equity. Mr. Mercer recommended in his direct testimony that the rate of return on equity be at least 11.75%. Mr. Mercer testified that he arrived at his opinion from a variety of considerations. Mr. Mercer stated that a reasonable return is one which is comparable to returns of others having comparable risks, ensures confidence and the financial integrity of the regulated utility, is sufficient for the utility to maintain its current credit, and will allow the utility to attract capital. Mr. Mercer indicated there are risks associated with the procurement of natural gas, competition with alternative fuels, credit concerns by suppliers to small gas utilities and the GCA process itself. Mr. Mercer noted that Petitioner has a negative income earnings pool, and that Petitioner's stock is unlisted on any exchange, and therefore, consideration should be given for the lack of liquidity of the stock.

OUCC's Position. Mr. Lorton testified that he believed Lawrenceburg's proposed return on equity was too high based on current and projected yields on risk-free Treasury bonds, estimates of the risk premium and return on equity by financial experts, and current trends in authorized return on equity in utility rate cases. Mr. Lorton noted that Lawrenceburg includes no debt in its capital structure, indicating no financial risk because investors do not have a claim on earnings prior to the payment of dividends. Mr. Lorton also noted that Lawrenceburg was authorized to implement a Normal Temperature Adjustment ("NTA") in IURC Cause No. 43141 which essentially eliminates weather risk.

Mr. Lorton recommended a cost of equity of 9.25%. He based his recommendation on his calculation of adding a reasonable risk premium to a risk-free rate of return. He chose a 10 year constant maturity U.S. Treasury bond as a risk free rate since U.S. Treasury securities are the standard for determining a risk-free rate of return and the 10 year period was most consistent with the duration from the Utility's last rate case. He testified that his recommended cost of equity was supported by a 2003 Lehman Brothers article and several other sources of economic forecast data. Mr. Lorton further testified that he had taken current and projected inflation into account in his analysis. Mr. Lorton observed that the U.S. economy remains in a relatively low inflation period, which tends to support lower interest rates and lower costs of financing capital investment, including investments in utility plant.

Finally, Mr. Lorton testified that he examined the annual Return on Equity surveys published in *Public Utilities Fortnightly* in November 2005 and November 2006. He testified that the data presented revealed a tendency toward rate cases resulting in lower return on equity

levels for utilities. He also noted that several cases in the past two years had resulted in returns on equity of less than 10%.

Petitioner's Rebuttal. Mr. Mercer stated he did not agree with Mr. Lorton's 9.25% cost of equity rate. Mr. Mercer said that he looked at the Commission's recent history in energy utility rate cases and found that returns of equity were in the 10.5% range. Mr. Mercer stated that he used this 10.5% range as a base level to which he added a premium to arrive at his proposed 11.75% return on equity. Mr. Mercer argued that the premium is justified because Lawrenceburg's stock is not publicly traded and it has two customers that represent approximately 51% of Lawrenceburg's annual throughput. He indicated that load retention is a major issue with these two customers.

Commission Discussion and Findings. We recognize that determining an appropriate cost of equity capital is not an exact science. Both parties have attempted to present statistical support for their respective positions, and we further appreciate the fact that Lawrenceburg elected not to incur the considerable expense of hiring a separate cost of capital expert witness.

Having reviewed the evidence presented by the parties, we are not convinced that Lawrenceburg's approach of adding a risk premium to a cost of equity percentage within the range of that which the Commission has recently approved for other utilities is appropriate in this case. While Mr. Mercer indicates that certain risks specific to Lawrenceburg justify an additional premium, he fails to indicate any justification for adding the premium to a cost of equity within the range of that approved by the Commission when such a cost of equity range likely includes other risk premiums that may or may not be applicable to Lawrenceburg. In addition, while Mr. Mercer states that an 11.75% cost of equity is comparable to returns of others having comparable risks, no evidence was offered to support his statement.

Therefore, we find the OUCC's method of adding appropriate risk premiums to a risk-free rate of return to determine an appropriate cost of equity capital to be a reasonable approach in this case. As Mr. Lorton noted, Lawrenceburg includes no debt in its capital structure and therefore has a lower financial risk than many other utilities because investors do not have a claim on earnings prior to any dividend payments. Consequently, we find the most recent Congressional Budget Office forecasted rate on 10 year Treasuries at 5.2% to be an appropriate starting point for the cost of equity determination.

We also find the OUCC's proposed premium of 3.93% to be a reasonable equity premium. As Mr. Lorton noted, such a premium is supported by the June 4, 2003, Lehman Brothers article entitled "A Blast from the Past: The Lull in Rate Cases is Coming to an End." Mr. Lorton also indicated that several risks cited by Lawrenceburg as justification for a higher cost of equity, such as weather and gas costs, are or have been mitigated by the quarterly gas cost adjustment procedure and the Commission's approval of an NTA for Lawrenceburg in Cause No. 43141. However, we also agree with Lawrenceburg's arguments that an additional risk premium of 1.25% is justified as reasonable in this case because Lawrenceburg is a small, non-publicly traded company and relies upon two large customers for more than half of its annual gas sales. Therefore, we find an appropriate return on equity for Petitioner is 10.4%.

B. <u>Customer Deposits.</u> Mr. Heid presented testimony regarding Lawrenceburg's customer deposits. Mr. Heid stated that he thought Lawrenceburg's current customer charges were significantly below the indicated fixed costs of providing service. Mr. Heid explained that with the exception of Rate WS to Aurora, all general service customers pay the same customer charge of \$9.11 per month regardless of meter size or other characteristics. In addition, Rate ITS and Rate ES customers do not have customer charges. He testified that Lawrenceburg's fixed costs should be recovered through the fixed monthly customer charges and variable costs should be recovered through volumetric charges.

Mr. Heid proposed three levels of customer charges to differentiate the costs of metering and related customer facilities for the different size customers in the Rate GS rate schedule. He suggested that customers with Group 1 meters (450 Cfh and less) be charged \$12.00 per month. He proposed that customers with Group 2 meters (above 450 Cfh up to and including 5000 Cfh) be billed a monthly customer charge of \$24.00. And Mr. Heid also proposed that customers with Group 3 meters (above 5000 Cfh) be billed a customer charge of \$75.00 per month.

Mr. Heid proposed an increase in the customer charge for Rate WS, the sale for resale service to Aurora. Mr. Heid proposed to increase the current customer charge of \$617.00 per month to \$900.00 as necessary to increase the proportion of allocated customer costs recovered by the customer charge. Mr. Heid also proposed to establish a monthly customer charge of \$75.00 for the Rate ITS interruptible transportation service and a monthly customer charge of \$250.00 for Rate ES, which is the economic stabilization service, as necessary to recover a portion of the allocated customer costs through a fixed charge.

OUCC's Position. Mr. Lorton presented testimony regarding Lawrenceburg's proposed increase in distribution rates, which includes both the customer charge and the delivery charge. Mr. Lorton testified that Lawrenceburg proposes to increase the monthly customer charge in both the Lawrenceburg and Brookville divisions from \$9.11 to \$12 for residential customers – an increase of 31.7%. Mr. Lorton went on to note that this increase was only for customers in Group 1 of Rate GS with meters of less than 450 cubic feet per hour capacity, which would apply primarily to residential and small business customers. Customers with larger meters (*i.e.*, Group 3), however, would see their monthly customer charge increase from \$9.11 to \$75, or 723.3%.

Aurora's Position. Mr. Patrick Callahan testified that Aurora did not object to Lawrenceburg's proposed increase in the monthly customer charge for Rate WS.

Commission Discussion and Findings. The Commission finds Mr. Heid's proposed increases in customer charges to be reasonable. As Mr. Heid noted, to the extent fixed costs are recovered through fixed charges, the rate design should result in a lower degree of bill volatility, prevent earnings erosion due to declining customer usage, and assist in aligning pricing with the costs incurred to serve the different customers.

While Mr. Lorton noted that the monthly customer charge for Group 3 of Rate GS was a rather large percentage increase over the current customer charge, it is interesting to note that the OUCC raised no objection to the Utility's proposed establishment of a customer charge for Rates ITS and ES, which is a substantial increase from no monthly customer charge. The only objection raised by the OUCC with regard to the proposed increase in customer charges was the percentage of the increase for those that currently pay a monthly customer charge. No evidence was presented that the proposed charges for Groups 1, 2 or 3 of Rate GS based upon the fixed costs incurred by Petitioner to serve these customers with differing meter sizes and characteristics was unreasonable. Therefore, the Commission finds that the monthly customer charges should be increased as proposed by the Petitioner.

Consequently, taking into account the above findings, we find Lawrenceburg's capital structure for the purpose of establishing rates in this cause is as follows:

<u>Lawrenceburg Capital Structure</u>

<u>Description</u>	<u>Amount</u>	% of Total	Cost	Weighted Cost
Common Equity	\$13,783,683	84.33%	10.4%	8.77%
Customer Deposits	\$ 220,416	1.35%	5.0%	0.07%
Deferred Taxes	\$ 2,340,509	14.32%	0.0%	0.00%
Total	\$16,344,608	100.00%		8.84%
1 Otal	φ10,544,000	100.00%		0.0470

- **9.** Rate Increase. Based on the findings above, we find that the Utility's present rates generate pro-forma annual revenue of \$3,460,458 and that its pro-forma test year operating expenses were \$2,897,834 producing pro-forma test year net operating income of \$562,624. We further find that Lawrenceburg is entitled to achieve net operating income of \$1,345,858 and accordingly we conclude that the Utility's rates should be increased to generate an additional \$783,235 in net operating income. Applying a revenue conversion factor of 1.6985 results in a total operating revenue increase of \$1,330,351.
- 10. Rate Design. Mr. Heid presented testimony regarding Lawrenceburg's cost of service study, the proposed revenue allocations among the rate schedules, the proposed rate design and levels of rates and charges applicable to each schedule, and the tariff for gas service. He testified that the Lawrenceburg Division has approximately 5,223 customers in its Rate G-1 General Service class, which is a firm sales service. The Brookville Division has approximately 969 customers in its Rate G-2 General Service class, which also is a firm sales service.

Mr. Heid testified that Rate ITS is an interruptible transportation service and has four customers. Rate ES is an employment stabilization and coal conversion service. This service is applicable to commercial and industrial customers who present evidence to the utility showing that absent special considerations, the customer faces severe economic hardship that can result in plant closings and loss of jobs to the local economy. At the present time, only one customer, Anchor Glass, is on Rate ES. Rate WS is a firm sale for resale service applicable solely to Aurora.

Mr. Heid testified that Lawrenceburg proposes to combine rate schedules G-1 and G-2 to form a single rate schedule, Rate GS-General Service, because Lawrenceburg believes that combining its two divisions for rate purposes will be administratively more efficient. He stated that there is no cost basis to maintain separate Lawrenceburg Division and Brookville Division rates. Mr. Heid explained that all plant in service, operation and maintenance expenses, and taxes are commingled. He testified that Lawrenceburg's capital requirements are not on a division basis, but rather on a total company basis. Mr. Heid stated that Lawrenceburg's costs of providing service are to a large extent common costs rather than division-specific costs. Mr. Heid testified that the Lawrenceburg and Brookville Divisions are managed and operated as a consolidated and coordinated whole, and that he did not think it made sense to try and distinguish among the customers on the basis of geography. He also noted that Lawrenceburg's large volume rate schedules – Rates ITS and ES – do not differentiate based on geographic location.

Mr. Heid sponsored a fully allocated cost of service study based on Lawrenceburg's embedded cost of providing gas service for the twelve months ended April 30, 2006. He testified that his objective in performing the cost of service study was to determine the rate of return on rate base that Lawrenceburg is earning from each customer class. According to Mr. Heid, this determination provides an indication as to whether its rates reflect the cost of providing service to each customer class.

Mr. Heid also proposed a revenue allocation among rate classes. He stated that his cost of service study served as the foundation for determining the revenue allocations he was proposing. Mr. Heid stated that the proposed Rate GS-General Service rate class is being provided a subsidy by the remaining rate schedules. Mr. Heid stated that Lawrenceburg's objective in its revenue allocation process was to reduce interclass subsidies to the extent practical while mitigating rate shock. He explained that Lawrenceburg's approach was to propose rates that moved toward equal rates of return and thereby reduce subsidies while producing reasonable percentage increases to each rate schedule. In this case, Lawrenceburg concluded that a 25% reduction in subsidies should be proposed.

OUCC's Position. Mr. Lorton testified that combining the General Service rates for the Lawrenceburg and Brookville divisions will result in a larger increase for those customers in the Brookville division because that division's rates are currently lower than the Lawrenceburg division. However, Mr. Lorton testified at the evidentiary hearing that the OUCC did not object to the combining of the Lawrenceburg and Brookville divisions.

Aurora's Position. Mr. Callahan expressed concern with the implementation of Lawrenceburg's proposed rates and charges. Mr. Callahan stated that under the proposed rate design, Aurora would be subsidizing Rate GS, and, according to his calculation, Aurora's rate of return is higher than all of the other rate classes. Mr. Callahan stated that he understood the Commission has in the past allowed utilities to ease into cost-based rates to avoid rate shock, but that the Commission has also allowed utilities to move completely to cost-based rates. Mr.

Callahan recommended that the Commission require Lawrenceburg to adjust its proposed rates and charges for Aurora to cost-based rates.

Mr. Callahan conceded that Aurora's proposed rate is lower than the proposed GS rate. However, he believes this is as it should be since Aurora has its own costs to pay. Mr. Callahan stated that it appears unfair for Aurora's customers to subsidize Lawrenceburg's customers when Lawrenceburg's customers on average earn the same or more than Aurora's customers.

Petitioner's Rebuttal. In response to the OUCC's concerns regarding the combining of the General Service rate for the Lawrenceburg and Brookville divisions, Mr. Heid reiterated his prior testimony that there is no cost basis for continuing to maintain separate division rates based upon the Utility's operations as a single company. Mr. Heid also stated that because the Utility has operated as consolidated whole, the Brookville division customers have been subsidized for many years by the Lawrenceburg division. Mr. Heid also testified that while customers in the Brookville division will experience a somewhat larger annual increase than those in the Lawrenceburg division, the increase, when gas costs are also considered, is not to the extent that it would cause rate shock.

Mr. Heid also presented rebuttal testimony addressing issues raised in Mr. Callahan's testimony regarding the level of subsidy reductions. Mr. Heid testified that the cost-based rates proposed by Mr. Callahan would result in a larger increase to Rate GS customers, including the residential customers, and would result in decreases to all remaining customer classes, including Aurora. Mr. Heid testified that under Lawrenceburg's proposed rates, Aurora is receiving only a minimal 1.4% increase, which is far below the increase being proposed to the other customer classes, and far below the overall system average increase of 13.98%. Mr. Heid presented testimony that showed under Mr. Callahan's proposal, Aurora would receive a 2.24% decrease; Rate ITS would receive a 9.44% decrease; and Rate ES would receive a 14.16% decrease. Conversely, Rate GS, including the residential customers, would receive a 19.70% increase in rates. Mr. Heid testified that a larger increase to Rate GS, combined with rate decreases to the remaining customers, is not a desirable result.

Commission Discussion and Findings. Lawrenceburg currently operates with two divisions – Lawrenceburg and Brookville – each with separate rates. Lawrenceburg has proposed in this case to eliminate these divisions and consolidate their general service rates into a single system-wide general service rate class. Neither of the other two parties opposed consolidating the Utility's two divisions as proposed, which we agree has merit. Although not physically interconnected, the Lawrenceburg and Brookville divisions are otherwise operated as a single, integrated entity. As the Utility's cost of service expert witness, Kerry A. Heid, testified, there is no cost basis for treating them separately. Accordingly, we find that Lawrenceburg should merge the general service rates for its two divisions into a single, system-wide general service rate.

The Commission finds that Lawrenceburg should implement its approved increase with a 25% subsidy reduction across-the-board as proposed by Mr. Heid. Mr. Callahan's proposed rate design, while advantageous to Aurora in the form of a small rate reduction, would result in a

larger rate increase, which is already substantial, to the majority of Lawrenceburg's customers. Therefore, we find that the more gradual subsidy reduction proposed by Lawrenceburg strikes an appropriate balance which in this case is reasonable for all of the Utility's ratepayers.

11. Affiliate Contracts. Mr. Grosskopf testified regarding the OUCC's concerns about Lawrenceburg's business relationships with affiliates. Mr. Grosskopf noted that a review of Lawrenceburg's books and records revealed that Lawrenceburg uses Premier Energy Services, LLC ("Premier") for almost all construction and maintenance activities. Mr. Grosskopf also testified that in response to discovery Lawrenceburg confirmed that Premier was not contracted through an open bidding process and that there was no contract between Lawrenceburg and Premier. Mr. Grosskopf also testified that he became aware that Mr. John Stenger, Vice President of Lawrenceburg, "owns a material interest in Premier" and therefore may present a conflict of interest.

Petitioner's Rebuttal. Mr. Stenger presented testimony addressing the OUCC's concerns with respect to Lawrenceburg purchasing services from Premier. He testified that he owns a fifty percent membership interest in Premier, which he helped found in 2002. Mr. Stenger stated that Premier performs maintenance and construction work for Lawrenceburg at pre-determined hourly and usage rates. Mr. Stenger admitted that at the time of his rebuttal testimony, there was no written contract between Lawrenceburg and Premier, but that Lawrenceburg intended to file an executed contract with the Commission by the end of the month (i.e., January). Mr. Stenger testified that Lawrenceburg and Premier agree upon rates at the beginning of each calendar year for completing large capital projects where the total cost of the project is expected to be less than \$100,000. Invoices for these projects are provided to Lawrenceburg on a weekly basis. Mr. Stenger stated that Lawrenceburg solicits bids for projects that are larger than \$100,000.

Commission Discussion and Findings. As an initial matter, the Commission would note that it shares the OUCC's concern about affiliate services being provided to a Commission regulated utility without an executed contract on file with the Commission. The Commission's rules and regulations are in place to protect the interests of the utility's ratepayers as well as the utility. The Commission, OUCC and other interested persons should have the opportunity to review affiliate contracts and determine whether these contracts are appropriate, reasonable and in the best interests of the ratepayers. Consequently, the Commission expects that Lawrenceburg will better comply with these rules in the future.

With regard to Lawrenceburg's affiliate relationship with Premier, Lawrenceburg purchases services from Premier primarily relating to the daily maintenance of the Utility's distribution system and for small construction projects. The OUCC identified no specific objection to any of the Utility's costs incurred through its employment of Premier, but instead recommended that the relationship should be committed to writing and filed with the Commission as an affiliate contract. Lawrenceburg did so on January 31, 2007. Therefore, the Commission finds no basis for further inquiry in this proceeding.

IT IS THEREFORE ORDERED BY THE INDIANA UTILITY REGULATORY COMMISSION, that:

- 1. Lawrenceburg Gas Company is hereby authorized to increase its rates and charges for gas utility service so as to produce an increase in operating revenues of \$1,330,351 in a manner consistent with the findings set forth above.
- 2. Lawrenceburg Gas Company shall file with the Natural Gas Division of the Commission, prior to placing into effect the new rates and charges herein approved, replacement tariff sheets reflecting the terms of this Order.
- 3. This Order shall be effective on and after the date of its approval, and shall apply to all bills rendered on or after that date.

HARDY, GOLC, SERVER AND ZIEGNER CONCUR; LANDIS ABSENT:

APPROVED: JUN 2 0 2007

I hereby certify that the above is a true and correct copy of the Order as approved.

Brenda A. Howe

Secretary to the Commission